of a life insurance company taxable under section 801, the amount of such stock that is treated as tax exempt shall not be reduced because a portion of the dividends received deduction is disallowed as attributable to the policyholder's share of such dividends. See §1.861–14T(h) for a special rule concerning the allocation of reserve expenses of a life insurance company. In addition, for purposes of apportioning deductions using an asset method, assets would not include that portion of stock equal to the portion of dividends paid thereon that would be deductible under either section 243(a)(1), section 243(a)(2), or section 245(a). In the case of stock which generates, has generated, or can reasonably be expected to generate qualifying dividends deductible under section 243(a)(3), such stock shall not constitute a tax exempt asset. Such stock and the dividends thereon will, however, be eliminated from consideration in the apportionment of interest expense under the consolidation rule set forth in §1.861–10T(c), and in the apportionment of other expenses under the consolidation rules set forth in §1.861–14T.

(C) *Foreign-derived intangible income and inclusions under section 951A(a).* For further guidance, see §1.861–8(d)(2)(ii)(C).

(iii) *Income that is not considered tax exempt.* The following items are not considered to be exempt, eliminated, or excluded income and, thus, may have expenses, losses, or other deductions allocated and apportioned to them:

(A) In the case of a foreign taxpayer (including a foreign sales corporation (FSC)) computing its effectively connected income, gross income (whether domestic or foreign source) which is not effectively connected to the conduct of a United States trade or business;

(B) In computing the combined taxable income of a DISC or FSC and its related supplier, the gross income of a DISC or a FSC; and

(C) For further guidance, see §1.861–8(d)(2)(iii)(C) through (E).

(D)–(E) [Reserved]

(iv) *Value of stock attributable to previously taxed earnings and profits.* For further guidance, see §1.861–8(d)(2)(iv).

(e) *Allocation and apportionment of certain deductions.* (1) [Reserved]. For further guidance, see §1.861–8(e)(1).

(2) *Interest.* The rules concerning the allocation and apportionment of interest expense and certain interest equivalents are set forth in §§1.861–9T through §1.861–13T.

(3) *Research and experimental expenditures.* For further guidance, see §1.861–8(e)(3) through (15).

(4)–(15) [Reserved]

(f) *Miscellaneous matters.* For further guidance, see §1.861–8(f) through (g).

(g) [Reserved]

(h) *Effective/applicability date.* (1) Paragraphs (f)(1)(vi)(E), (f)(1)(vi)(F), and (f)(1)(vi)(G) of this section apply to taxable years ending after April 9, 2008.

(2) Paragraph (e)(4), the last sentence of paragraph (f)(4)(i), and paragraph (g), *Examples 17*, *18*, and *30* of this section apply to taxable years beginning after July 31, 2009.

(3) Also, *see* paragraph (e)(12)(iv) of this section and 1.861–14(e)(6) for rules concerning the allocation and apportionment of deductions for charitable contributions.

[T.D. 8228, 53 FR 35474, Sept. 14, 1988]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.861–8T, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 1.861–9 Allocation and apportionment of interest expense and rules for asset-based apportionment.

(a) *In general.* For further guidance, see §1.861–9T(a) through (b).

(b) [Reserved]

(c) *Allowable deductions.* For further guidance, see §1.861–9T(c) introductory text.

(1) *Disallowed deductions.* For further guidance, see §1.861–9T(c)(1) through (4).

(2)–(4) [Reserved]

(5) *Section 163(j).* If a taxpayer is subject to section 163(j), the taxpayer's deduction for business interest expense is limited to the sum of the taxpayer's business interest income, 30 percent of the taxpayer's adjusted taxable income for the taxable year, and the taxpayer's floor plan financing interest expense. In the taxable year that any deduction

is permitted for business interest expense with respect to a disallowed business interest carryforward, that business interest expense is apportioned for purposes of this section under rules set forth in paragraph (d), (e), or (f) of this section (as applicable) as though it were incurred in the taxable year in which the expense is deducted.

(d) *Apportionment rules for individuals, estates, and certain trusts.* For further guidance, see §1.861–9T(d).

(e) *Partnerships*—(1) *In general—aggregate rule.* For further guidance, see §1.861–9T(e)(1).

(2) *Corporate partners whose interest in the partnership is 10 percent or more.* A corporate partner shall apportion its interest expense, including the partner's distributive share of partnership interest expense, by reference to the partner's assets, including the partner's pro rata share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2).

(3) *Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more.* An individual partner is subject to the rules of this paragraph (e)(3) if either the individual is a general partner or the individual's direct and indirect interest (as determined under the attribution rules of section 318) in the partnership is 10 percent or more. The individual shall first classify his or her distributive share of partnership interest expense as interest incurred in the active conduct of a trade or business, as passive activity interest, or as investment interest under regulations issued under sections 163 and 469. The individual must then apportion his or her interest expense, including the partner's distributive share of partnership interest expense, under the rules of paragraph (d) of this section. Each such individual partner shall take into account his or her distributive share of the partnership gross income or pro rata share of the partnership assets in applying such rules. An individual using the tax book value or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2).

(4) *Entity rule for less than 10 percent limited partners*—(i) *Partnership interest expense.* A limited partner (whether individual or corporate), whose ownership, together with ownership by persons that bear a relationship to the partner described in section 267(b) or section 707, of the capital and profits interests of the partnership is less than 10 percent directly allocates its distributive share of partnership interest expense to its distributive share of partnership gross income. Under §1.904–4(n)(1)(ii), such a partner's distributive share of foreign source income of the partnership is treated as passive income (subject to the high-taxed income exception of section 904(d)(2)(B)(iii)(II)), except in the case of income from a partnership interest held in the ordinary course of the partner's active trade or business, as defined in §1.904–4(n)(1)(ii)(B). A partner's distributive share of partnership interest expense (other than partnership interest expense that is directly allocated to identified property under §1.861–10T) is apportioned in accordance with the partner's relative distributive share of gross foreign source income in each separate category and of gross domestic source income from the partnership. To the extent that partnership interest expense is directly allocated under §1.861–10T, a comparable portion of the income to which such interest expense is allocated is disregarded in determining the partner's relative distributive share of gross foreign source income in each separate category and domestic source income. The partner's distributive share of the interest expense of the partnership that is directly allocable under §1.861–10T is allocated according to the treatment, after application of

§ 1.904–4(n)(1), of the partner's distributive share of the income to which the expense is allocated.

(ii) *Other interest expense of the partner.* For further guidance, see § 1.861–9T(e)(4)(ii).

(5) *Tiered partnerships.* For further guidance, see § 1.861–9T(e)(5) through (7).

(6)–(7) [Reserved]

(8) *Special rule for downstream partnership loans*—(i) *In general.* For purposes of apportioning interest expense that is not directly allocable under paragraph (e)(4) of this section or § 1.861–10T, the disregarded portion of a downstream partnership loan is not considered an asset of a downstream partnership loan lender (DPL lender). The disregarded portion of a downstream partnership loan is the portion of the value of the loan (as determined under paragraph (h)(4)(i) of this section) that bears the same proportion to the total value of the loan as the matching income amount that is included by the DPL lender for a taxable year with respect to the loan bears to the total amount of downstream partnership loan interest income (DPL interest income) that is included directly or indirectly in gross income by the DPL lender with respect to the loan during that taxable year.

(ii) *Treatment of interest expense and interest income attributable to a downstream partnership loan.* If a DPL lender (or any other person in the same affiliated group as the DPL lender) takes into account a distributive share of downstream partnership loan interest expense (DPL interest expense), the DPL lender must assign an amount of DPL interest income corresponding to the matching income amount for the taxable year that is attributable to the same loan to the same statutory and residual groupings as the statutory and residual groupings of gross income from which the DPL interest expense is deducted (or would be deducted, without regard to any limitations on the deductibility of interest, such as section 163(j)) by the DPL lender (or any other person in the same affiliated group as the DPL lender).

(iii) *Anti-avoidance rule for third party back-to-back loans.* If, with a principal purpose of avoiding the rules in this paragraph (e)(8), a person makes a loan to a person that is not related (within the meaning of section 267(b) or 707) to the lender, the unrelated person makes a loan to a partnership, and the first loan would constitute a downstream partnership loan if made directly to the partnership, then the rules of this paragraph (e)(8) apply as if the first loan was made directly to the partnership and the interest expense paid by the partnership is treated as made with respect to the first loan. Such a series of loans will be subject to this recharacterization rule without regard to whether there was a principal purpose of avoiding the rules in this paragraph (e)(8) if the loan to the unrelated person would not have been made or maintained on substantially the same terms but for the loan of funds by the unrelated person to the partnership. The principles of this paragraph (e)(8)(iii) also apply to similar transactions that involve more than two loans and regardless of the order in which the loans are made.

(iv) *Anti-avoidance rule for loans held by CFCs.* A loan receivable held by a controlled foreign corporation with respect to a loan to a partnership in which a United States shareholder (as defined in § 1.904–5(a)(4)(vi)) of the controlled foreign corporation owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities (as defined in § 1.904–5(a)(4)(iv)), is recharacterized as a loan receivable held directly by the United States shareholder with respect to the loan to such partnership for purposes of this paragraph (e)(8) if the loan was made or transferred with a principal purpose of avoiding the rules in this paragraph (e)(8). An appropriate amount of income derived by the United States shareholder (or any other person in the same affiliated group as the United States shareholder) from the controlled foreign corporation is treated as DPL interest income. Appropriate adjustments must be made to the value and characterization of the stock of the controlled foreign corporation under §§ 1.861–9 and 1.861–12 in order to reflect the portion of the downstream partnership loan held by the controlled foreign corporation that is disregarded under paragraph (e)(8)(i) of this section.

(v) *Interest equivalents.* The principles of this paragraph (e)(8) apply in the case of a partner, or any person in the same affiliated group as the partner, that takes into account a distributive share of an expense or loss (to the extent deductible) that is allocated and apportioned in the same manner as interest expense under §§1.861–9(b) and 1.861–9T(b) and has a matching income amount (treating such interest equivalent as interest income or expense for purposes of paragraph (e)(8)(vi)(B) of this section) with respect to the transaction that gives rise to that expense or loss.

(vi) *Definitions.* For purposes of this paragraph (e)(8), the following definitions apply.

(A) *Affiliated group.* The term *affiliated group* has the meaning provided in §1.861–11(d)(1).

(B) *Matching income amount.* The term *matching income amount* means the lesser of the total amount of the DPL interest income included directly or indirectly in gross income by the DPL lender for the taxable year with respect to a downstream partnership loan or the total amount of the distributive shares of the DPL interest expense of the DPL lender (or any other person in the same affiliated group as the DPL lender) with respect to the loan.

(C) *Downstream partnership loan.* The term *downstream partnership loan* means a loan to a partnership for which the loan receivable is held, directly or indirectly through one or more other partnerships or other pass-through entities, either by a person that owns an interest, directly or indirectly through one or more other partnerships or other pass-through entities, in the partnership, or by any person in the same affiliated group as that person.

(D) *Downstream partnership loan interest expense (DPL interest expense).* The term *downstream partnership loan interest expense,* or *DPL interest expense,* means an item of interest expense paid or accrued with respect to a downstream partnership loan, without regard to whether the expense was currently deductible (for example, by reason of section 163(j)).

(E) *Downstream partnership loan interest income (DPL interest income).* The term *downstream partnership loan interest income,* or *DPL interest income,* means an item of gross interest income received or accrued with respect to a downstream partnership loan.

(F) *Downstream partnership loan lender (DPL lender).* The term *downstream partnership loan lender,* or *DPL lender,* means the person that holds the receivable with respect to a downstream partnership loan. If a partnership holds the receivable, then any partner in the partnership (other than a partner described in paragraph (e)(4)(i) of this section) is also considered a DPL lender.

(vii) *Examples.* The following examples illustrate the application of the rules in this paragraph (e)(8).

(A) *Example 1*—(*1*) *Facts.* US1, a domestic corporation, directly owns 60% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 40% of PRS is directly owned by US2, a domestic corporation that is unrelated to US1. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, US1 loans $1,000x to PRS. For Year 1, US1 has $100x of interest income with respect to the loan and PRS has $100x of interest expense with respect to the loan. US1's distributive share of the interest expense is $60x. Under paragraph (e)(2) of this section, $45x of US1's distributive share of the interest expense is apportioned to U.S. source income and $15x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between US1 and PRS is $1,000x.

(*2*) *Analysis.* The loan by US1 to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $60x, the lesser of the DPL interest income included by US1 with respect to the loan for the taxable year ($100x) and US1's distributive share of the DPL interest expense ($60x). Under paragraph (e)(8)(ii) of this section, US1 assigns $45x of the DPL interest income to U.S. source income and $15x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $40x of US1's DPL interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $600x ($1,000x × $60x/$100x).

(B) *Example 2*—(*1*) *Facts*. The facts are the same as in paragraph (e)(8)(vii)(A)(*1*) of this section (the facts in *Example 1*), except that US1 and US2 are part of the same affiliated group, US2's distributive share of the interest expense is $40x, and under paragraph (e)(2) of this section, $30x of US2's distributive share of the interest expense is apportioned to U.S. source income and $10x is apportioned to foreign source foreign branch category income.

(*2*) *Analysis*. The loan by US1 to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $100x, the lesser of the DPL interest income included by US1 with respect to the loan for the taxable year ($100x) and the total amount of US1 and US2's distributive shares of the DPL interest expense ($100x). Under paragraph (e)(8)(ii) of this section, US1 assigns $75x of the DPL interest income to U.S. source income and $25x of the DPL interest income to foreign source foreign branch category income. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $1,000x ($1,000x × $100x/$100x).

(C) *Example 3*—(*1*) *Facts*. US1, a domestic corporation, owns 80% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 20% of PRS is owned by US2, a domestic corporation that is unrelated to US1. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, US1 loans $3,000x to Bank and Bank loans $3,000x to PRS. US1 makes the loan to Bank with a principal purpose of avoiding the rules in this paragraph (e)(8). For Year 1, US1 has $150x of interest income with respect to the loan to Bank and PRS has $175x of interest expense with respect to the loan from Bank. US1's distributive share of the interest expense is $140x. Under paragraph (e)(2) of this section, $126x of US1's distributive share of the interest expense is apportioned to U.S. source income and $14x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between US1 and PRS is $3,000x.

(*2*) *Analysis*. Under paragraph (e)(8)(iii) of this section, because the loan from US1 to Bank is made with a principal purpose of avoiding the rules of this paragraph (e)(8), the rules of this paragraph (e)(8) apply as if the loan by US1 to Bank was made directly to PRS. Accordingly, the loan by US1 to Bank is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $140x, the lesser of the DPL interest income included by US1 with respect to the loan for the taxable year ($150x) and US1's distributive share of the DPL interest expense ($140x). Under paragraph (e)(8)(ii) of this section, US1 assigns $126x of the DPL interest income to U.S. source income and $14x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $10x of US1's DPL interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $2,800x ($3,000x × $140x/$150x).

(D) *Example 4*—(*1*) *Facts*. US1, a domestic corporation, directly owns all of the outstanding stock of CFC, a controlled foreign corporation, and 90% of PRS, a foreign partnership that is not engaged in a U.S. trade or business. The remaining 10% of PRS is owned by US2, a domestic corporation that is unrelated to US1 and CFC. US1, US2, and PRS all use the calendar year as their taxable year. In Year 1, US1 loans $900x to CFC and CFC loans $900x to PRS. CFC makes the loan with a principal purpose of avoiding the rules in this paragraph (e)(8). For Year 1, CFC has $90x of interest income and $90x of interest expense with respect to the loan to PRS, and US1 has $90x of interest income with respect to the loan to CFC. PRS has $90x of interest expense with respect to the loan, and US1's distributive share of the interest expense is $81x. Under paragraph (e)(2) of this section, $54x of US1's distributive share of the interest expense is apportioned to U.S. source income and $27x is apportioned to foreign source foreign branch category income. Under paragraph (h)(4)(i) of this section, the total value of the loan between CFC and PRS is $900x.

(*2*) *Analysis*. Under paragraph (e)(8)(iv) of this section, because the loan from CFC to PRS is made with a principal purpose of avoiding the rules of this paragraph (e)(8), the loan from CFC to PRS is recharacterized as a loan receivable held directly by US1, and an appropriate amount of income derived by US1, in this case, the $90x of interest income from the loan to CFC, is treated as DPL interest income. Accordingly, the loan from CFC to PRS is a downstream partnership loan and US1 is a DPL lender. Under paragraph (e)(8)(vi)(B) of this section, the matching income amount is $81x, the lesser of the DPL interest income included by US1 ($90x) and US1's distributive share of the DPL interest expense ($81x). Under paragraph (e)(8)(ii) of this section, US1 assigns $54x of the DPL interest income to U.S. source income and $27x of the DPL interest income to foreign source foreign branch category income. The source and separate category of the remaining $9x of US1's interest income is determined under the generally applicable rules. Under paragraph (e)(8)(i) of this section, the disregarded portion of the downstream partnership loan is $810x ($900x x $81x/$90x). Appropriate adjustments are made to the value and characterization of the stock of CFC under §§ 1.861–9 and 1.861–12 in order to reflect the $810x disregarded portion of the downstream partnership loan.

(9) [Reserved]

(10) *Characterizing certain partnership assets as foreign branch category assets*. For purposes of applying this paragraph (e) to section 904 as the operative section, a partner that is a United States person that has a distributive share of partnership income that is treated as foreign branch category income under § 1.904–4(f)(1)(i)(B) characterizes its pro rata share of the partnership assets that give rise to such income as assets in the foreign branch category.

(f) *Corporations*—(1) *Domestic corporations*. For further guidance, see § 1.861–9T(f)(1).

(2) *Section 987 QBUs of domestic corporations*—(i) *In general*. In the application of the asset method described in paragraph (g) of this section, a domestic corporation—

(A) Takes into account the assets of any section 987 QBU (as defined in § 1.987–1(b)(2)), translated according to the rules set forth in paragraph (g) of this section; and

(B) Combines with its own interest expense any deductible interest expense incurred by a section 987 QBU, translated according to the rules under section 987.

(ii) *Coordination with section 987(3)*. For purposes of computing foreign currency gain or loss under section 987(3) (including section 987 gain or loss recognized under § 1.987–5), the rules of this paragraph (f)(2) do not apply. *See* § 1.987–4.

(iii) *Example*. The following example illustrates the application of the rules in this paragraph (f)(2).

(A) *Facts*. X is a domestic corporation that operates B, a branch doing business in a foreign country. B is a section 987 QBU (as defined in § 1.987–1(b)(2)) as well as a foreign branch (as defined in § 1.904–4(f)(3)(iii)). In 2020, without regard to B, X has gross domestic source income of $1,000x and gross foreign source general category income of $500x and incurs $200 of interest expense. Using the tax book value method of apportionment, X, without regard to B, determines the value of its assets that generate domestic source income to be $6,000x and the value of its assets that generate foreign source general category income to be $1,000x. Applying the translation rules of section 987, X (through B) earned $500 of gross foreign source foreign branch category income and incurred $100x of interest expense. B incurred no other expenses. For 2020, the average functional currency book value of B's assets that generate foreign source foreign branch category income translated at the year-end rate for 2020 is $3,000x.

(B) *Analysis*. The combined assets of X and B for 2020 (averaged under §1.861–9T(g)(3)) consist 60% ($6,000x/$10,000x) of assets generating domestic source income, 30% ($3,000x/$10,000x) of assets generating foreign source foreign branch category income, and 10% ($1,000x/$10,000x) of assets generating foreign source general category income. The combined interest expense of X and B is $300x. Thus, $180x ($300x x 60%) of the combined interest expense is apportioned to domestic source income, $90x ($300x × 30%) is apportioned to foreign source foreign branch category income, and $30x ($300x × 10%) is apportioned to foreign source general category income, yielding net U.S. source income of $820 ($1,000x − $180x), net foreign source foreign branch category income of $410 ($500x − $90x), and net foreign source general category income of $470x ($500x − $30x).

(3) *Controlled foreign corporations*—(i) *In general*. For purposes of computing subpart F income and tested income and computing earnings and profits for all Federal income tax purposes, the interest expense of a controlled foreign corporation may be apportioned using either the asset method described in paragraph (g) of this section or the modified gross income method described in paragraph (j) of this section, subject to the rules of paragraphs (f)(3)(ii) and (iii) of this section.

(ii) *Manner of election*. The election shall be made by filing the statement and providing the written notice described in §1.964–1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein. For further guidance, *see* §1.861–9T(f)(3)(ii).

(f)(3)(iii)–(iv) [Reserved] For further guidance, *see* §1.861–9T(f)(3)(iii) and (iv).

(4) *Noncontrolled 10-percent owned foreign corporations*.—(i) *In general*. For purposes of computing earnings and profits of a noncontrolled 10-percent owned foreign corporations (as defined in section 904(d)(2)(E)) for Federal tax purposes, the interest expense of a noncontrolled 10-percent owned foreign corporations may be apportioned using either the asset method described in §1.861–9T(g) or the modified gross income method described in §1.861–9T(j). A noncontrolled 10-percent owned foreign corporations that is not a controlled foreign corporation may elect to use a different method of apportionment than that elected by one or more of its shareholders. A noncontrolled 10-percent owned foreign corporations must use the same method of apportionment with respect to all its domestic corporate shareholders.

(ii) *Manner of election*. The election to use the asset method described in §1.861–9T(g) or the modified gross income method described in §1.861–9T(j) may be made either by the noncontrolled 10-percent owned foreign corporations or by the majority domestic corporate shareholders (as defined in §1.964–1(c)(5)(ii)) on behalf of the noncontrolled 10-percent owned foreign corporations. The election shall be made by filing the statement and providing the written notice described in §1.964–1(c)(3)(ii) and (iii), respectively, at the time and in the manner described therein.

(iii) *Stock characterization*. The stock of a noncontrolled 10-percent owned foreign corporation is characterized under the rules in §1.861–12(c)(4).

(5) *Other relevant provisions*. For further guidance, see §1.861–9T(f)(5).

(g) *Asset method*—(1) *In general*. (i) For further guidance, see §1.861–9T(g)(1)(i).

(ii) A taxpayer may elect to determine the value of its assets on the basis of either the tax book value or the fair market value of its assets. However, for taxable years beginning after December 31, 2017, the fair market value method is not allowed with respect to allocations and apportionments of interest expense. *See* section 864(e)(2). For rules concerning the application of an alternative method of valuing assets for purposes of the tax book value method, see paragraph (i) of this section. For rules concerning the application of the fair market value method, see paragraph (h) of this section.

(iii) [Reserved]

(iv) For rules relating to earnings and profits adjustments by taxpayers using the tax book value method for the stock in certain 10 percent owned corporations, see §1.861–12(c)(2).

(v) [Reserved]

(2) *Asset values*—(i) *General rule*—(A) *Average of values*. For purposes of determining the value of assets under this section, an average of values (book or market) within each statutory grouping and the residual grouping is computed for the year on the basis of values of assets at the beginning and end of the year. For the first taxable year beginning after December 31, 2017 (*post-2017 year*), a taxpayer that determined the value of its assets on the basis of the fair market value method for purposes of apportioning interest expense in its prior taxable year may choose to determine asset values under the tax book value method (or the alternative tax book value method) by treating the value of its assets as of the beginning of the post-2017 year as equal to the value of its assets at the end of the first quarter of the post-2017 year, provided that each member of the affiliated group (as defined in §1.861–11T(d)) determines its asset values on the same basis. Where a substantial distortion of asset values would result from averaging beginning-of-year and end-of-year values, as might be the case in the event of a major corporate acquisition or disposition, the taxpayer must use a different method of asset valuation that more clearly reflects the average value of assets weighted to reflect the time such assets are held by the taxpayer during the taxable year.

(B) *Tax book value method*. Under the tax book value method, the value of an asset is determined based on the adjusted basis of the asset. For purposes of determining the value of stock in a 10 percent owned corporation at the beginning and end of the year under the tax book value method, the tax book value is determined without regard to any adjustments under section 961(a) or 1293(d), see §1.861–12(c)(2)(i)(B)(*1*), and before the adjustment required by §1.861–12(c)(2)(i)(A) to the basis of stock in the 10 percent owned corporation. The average of the tax book value of the stock at the beginning and end of the year is then adjusted with respect to earnings and profits as described in §1.861–12(c)(2)(i).

(ii) *Special rule for qualified business units of domestic corporations with functional currency other than the U.S. dollar*—(A) *Tax book value method*. For further guidance, see §1.861–9T(g)(2)(ii)(A).

(*1*) *Section 987 QBU*. For further guidance, see §1.861–9T(g)(2)(ii)(A)(*1*).

(*2*) *U.S. dollar approximate separate transactions method*. In the case of a branch to which the U.S. dollar approximate separate transactions method of accounting described in §1.985–3 applies, the beginning-of-year dollar amount of the assets is determined by reference to the end-of-year balance sheet of the branch for the immediately preceding taxable year, adjusted for U.S. generally accepted accounting principles and Federal income tax accounting principles, and translated into U.S. dollars as provided in §1.985–3(c). The end-of-year dollar amount of the assets of the branch is determined in the same manner by reference to the end-of-year balance sheet for the current taxable year. The beginning-of-year and end-of-year dollar tax book value of assets, as so determined, within each grouping is then averaged as provided in paragraph (g)(2)(i) of this section.

(B) *Fair market value method*. For further guidance, see §1.861–9T(g)(2)(ii)(B).

(iii) *Adjustment for directly allocated interest*. For further guidance, see §1.861–9T(g)(2)(iii).

(iv) *Assets in intercompany transactions*. For further guidance, see §1.861–9T(g)(2)(iv).

(3) *Characterization of assets*. For further guidance, see §1.861–9T(g)(3).

(4) *Characterization of lower tier entities at the level of a CFC*. In the case of a controlled foreign corporation that is applying the asset method, see for example §1.861–12T(c)(3)(ii) (requiring the application of §1.861–9T(g) at the level of the controlled foreign corporation) or paragraph (f)(3)(i) of this section, the controlled foreign corporation (and any lower-tier controlled foreign corporations) must characterize stock of a lower-tier 10 percent owned corporation by applying §1.861–12 and treating the controlled foreign corporation as the relevant taxpayer for such purposes. In the case of a controlled foreign corporation that owns stock in one or more lower-tier corporations, in applying the asset method, the first-tier controlled foreign corporation must take into account the stock in

the lower-tier corporations. Therefore, the controlled foreign corporation (and any lower-tier controlled foreign corporations) must make basis adjustments in lower-tier 10 percent owned corporations under § 1.861–12(c)(2) for purposes of valuing and characterizing the assets of such controlled foreign corporation. For purposes of this paragraph (g)(4), the stock of each such lower-tier corporation is characterized by reference to the assets owned during the lower-tier corporation's taxable year that ends during the first-tier controlled foreign corporation's taxable year. The analysis of assets under this paragraph (g)(4) and § 1.861–12 of a controlled foreign corporation that is in a chain of 10 percent owned corporations must begin at the lowest-tier 10 percent owned corporation and proceed up the chain to the first-tier controlled foreign corporation. *See also* § 1.861–12T(c)(3)(ii).

(h) *Fair market value method.* An affiliated group (as defined in § 1.861–11T(d)) or other taxpayer (the *taxpayer*) that elects to use the fair market value method of apportionment values its assets according to the methodology described in this paragraph (h). Effective for taxable years beginning after December 31, 2017, the fair market value method is not allowed for purposes of apportioning interest expense. *See* section 864(e)(2). However, a taxpayer may continue to apportion deductions other than interest expense that are properly apportioned based on fair market value according to the methodology described in this paragraph (h). *See* § 1.861–8(c)(2).

(1) *Determination of values.* For further guidance, see § 1.861–9T(h)(1) through (3).

(2)–(3) [Reserved]

(4) *Valuing related party debt and stock in related persons*—(i) *Related party debt.* For purposes of this section, the value of a debt obligation of a related person held by the taxpayer or another person related to the taxpayer equals the amount of the liability of the obligor related person.

(ii) *Stock in related persons.* The value of stock in a related person held by the taxpayer or by another person related to the taxpayer equals the sum of the following amounts reduced by the taxpayer's pro rata share of liabilities of such related person:

(A) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under § 1.861–9T(h)(2);

(B) The taxpayer's pro rata share of tangible assets held by the related person (as determined under § 1.861–9T(h)(1)(ii));

(C) The taxpayer's pro rata share of debt obligations of any related person held by the related person (as valued under paragraph (h)(4)(i) of this section); and

(D) The total value of stock in all related persons held by the related person as determined under this paragraph (h)(4).

(iii) *Example*—(A) *Facts.* USP, a domestic corporation, wholly owns CFC1 and owns 80% of CFC2, both foreign corporations. The aggregate trading value of USP's stock traded on established securities markets at the end of Year 1 is $700 and the amount of USP's liabilities to unrelated persons at the end of Year 1 is $400. Neither CFC1 nor CFC2 has liabilities to unrelated persons at the end of Year 1. USP owns plant and equipment valued at $500, CFC1 owns plant and equipmen t valued at $400, and CFC2 owns plant and equipment valued at $250. The value of these assets has been determined using generally accepted valuation techniques, as required by § 1.861–9T(h)(1)(ii). There is an outstanding loan from CFC2 to CFC1 in an amount of $100. There is also an outstanding loan from USP to CFC1 in an amount of $200.

(B) *Valuation of group assets.* Pursuant to § 1.861–9T(h)(1)(i), the aggregate value of USP's assets is $1100 (the $700 trading value of USP's stock increased by $400 of USP's liabilities to unrelated persons).

(C) *Valuation of tangible assets.* Pursuant to § 1.861–9T(h)(1)(ii), the value of USP's tangible assets and pro rata share of assets held by CFC1 and CFC2 is $1100 (the plant and equipment held directly by USP, valued at $500, plus USP's 100% pro rata share of the plant and equipment held by CFC1 valued at $400 and USP's 80% pro rata share of the plant and equipment held by CFC 2 valued at $200 (80% of $250)).

(D) *Computation of intangible asset value.* Pursuant to § 1.861–9T(h)(1)(iii), the value of the intangible assets of USP, CFC1, and CFC2 is $0 (total aggregate group asset value ($1100) determined in paragraph (B) less total tangible asset value ($1100) determined in paragraph (C)). Because the intangible asset value is zero, the provisions of § 1.861–9T(h)(2) and (3) relating to the apportionment and characterization of intangible assets do not apply.

(E) *Valuing related party debt obligations.* Pursuant to § 1.861–9(h)(4)(i), the value of the debt obligation of CFC1 held by CFC2 is equal to the amount of the liability, $100. The value of the debt obligation of CFC1 held by USP is equal to the amount of the liability, $200.

(F) *Valuing the stock of CFC1 and CFC2.* Pursuant to § 1.861–9(h)(4)(ii), the value of the stock of CFC2 held by USP is $280 (USP's 80% pro rata share of tangible assets of CFC2 included in paragraph (C) ($200) plus USP's 80% pro rata share of the debt obligation of CFC1 held by CFC2 valued in paragraph (E) ($80). The value of the stock of CFC1 held by USP is $100 (USP's 100% pro rata share of tangible assets of CFC1 included in paragraph (C) ($400) less USP's 100% pro rata share of the liabilities of CFC1 to USP and CFC2 ($300)).

(5) *Characterizing stock in related persons.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of § 1.861–12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under § 1.861–9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904–4(b)).

(6) [Reserved]. For further guidance, see § 1.861–9T(h)(6).

(i) *Alternative tax book value method*—(1) *Alternative value for certain tangible property.* A taxpayer may elect to determine the tax book value of its tangible property that is depreciated under section 168 (section 168 property) using the rules provided in this paragraph (i)(1) (the alternative tax book value method). The alternative tax book value method applies solely for purposes of apportioning expenses (including the calculation of the alternative minimum tax foreign tax credit pursuant to section 59(a)) under the asset method described in paragraph (g) of this section.

(i) The tax book value of section 168 property placed in service during or after the first taxable year to which the election to use the alternative tax book value method applies shall be determined as though such property were subject to the alternative depreciation system set forth in section 168(g) (or a successor provision) for the entire period that such property has been in service.

(ii) In the case of section 168 property placed in service prior to the first taxable year to which the election to use the alternative tax book value method applies, the tax book value of such property shall be determined under the depreciation method, convention, and recovery period provided for under section 168(g) for the first taxable year to which the election applies.

(iii) If a taxpayer revokes an election to use the alternative tax book value method (the prior election) and later makes another election to use the alternative tax book value method (the subsequent election) that is effective for a taxable year that begins within 3 years of the end of the last taxable year to which the prior election applied, the taxpayer shall determine the tax book value of its section 168 property as though the prior election has remained in effect.

(iv) The tax book value of section 168 property shall be determined without regard to the election to expense certain depreciable assets under section 179.

(v) *Examples.* The provisions of this paragraph (i)(1) are illustrated in the following examples:

Example 1. In 2000, a taxpayer purchases and places in service section 168 property used solely in the United States. In 2005, the taxpayer elects to use the alternative tax book value method, effective for the current taxable year. For purposes of determining the tax book value of its section 168 property, the taxpayer's depreciation deduction is determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) as in effect in 2005 to the taxpayer's original cost basis in such property. In 2006, the taxpayer acquires and places in service in the United States new section 168 property. The tax book value of this section 168 property is determined under the rules of section 168(g)(2) applicable to property placed in service in 2006.

Example 2. Assume the same facts as in *Example 1*, except that the taxpayer revokes the alternative tax book value method election effective for taxable year 2010. Additionally, in 2011, the taxpayer acquires new section 168 property and places it in service in the United States. If the taxpayer elects to use the alternative tax book value method effective for taxable year 2012, the taxpayer must determine the tax book value of its section 168 property as though the prior election still applied. Thus, the tax book value of property placed in service prior to 2005 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in 2005. The tax book value of section 168 property placed in service during any taxable year after 2004 would be determined by applying the method, convention, and recovery period rules of the alternative depreciation system under section 168(g)(2) applicable to property placed in service in such taxable year.

(2) *Timing and scope of election.* (i) Except as provided in this paragraph (i)(2)(i), a taxpayer may elect to use the alternative tax book value method. For the taxpayer's first taxable year beginning after December 31, 2017, the Commissioner's approval is not required to switch from the fair market value method to the alternative tax book value method for purposes of apportioning interest expense. Any election made pursuant to this paragraph (i)(2)(i) shall apply to all members of an affiliated group of corporations as defined in §§ 1.861–11(d) and 1.861–11T(d). Any election made pursuant to this paragraph (i)(2)(i) shall apply to all subsequent taxable years of the taxpayer unless revoked by the taxpayer. Revocation of such an election, other than in conjunction with an election to use the fair market value method, for a taxable year prior to the sixth taxable year for which the election applies requires the consent of the Commissioner.

(ii) *Example.* The provisions of this paragraph (i)(2) are illustrated in the following example:

Example. Corporation X, a calendar year taxpayer, elects on its original, timely filed tax return for the taxable year ending December 31, 2007, to use the alternative tax book value method for its 2007 year. The alternative tax book value method applies to Corporation X's 2007 year and all subsequent taxable years. Corporation X may not, without the consent of the Commissioner, revoke its election and determine tax book value using a method other than the alternative tax book value method with respect to any taxable year beginning before January 1, 2012. However, Corporation X may automatically elect to change from the alternative tax book value method to the fair market value method for any open year.

(3) *Certain other adjustments.* [Reserved]

(j) *Modified gross income method.* For further guidance, see § 1.861–9T(j) introductory text.

(1) For further guidance, see § 1.861–9T(j)(1).

(2) For further guidance, see § 1.861–9T(j)(2) introductory text.

(i) *Step 1.* For further guidance, see § 1.861–9T(j)(2)(i).

(ii) *Step 2.* Moving to the next higher-tier controlled foreign corporation, combine the gross income of such corporation within each grouping with its pro rata share (as determined under principles similar to section 951(a)(2)) of the gross income net of interest expense of all lower-tier controlled foreign corporations held by such higher-tier corporation within the same grouping adjusted as follows:

(A) Exclude from the gross income of the higher-tier corporation any dividends or other payments received from the lower-tier corporation other than interest income received from the lower-tier corporation;

(B) Exclude from the gross income net of interest expense of any lower-tier corporation any gross subpart F income, net of interest expense apportioned to such income;

(C) Then apportion the interest expense of the higher-tier controlled foreign corporation based on the adjusted combined gross income amounts; and

(D) Repeat paragraphs (j)(2)(ii)(A) through (C) of this section for each next higher-tier controlled foreign corporation in the chain.

(k) *Applicability date.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

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§ 1.861–9T Allocation and apportionment of interest expense (temporary).

(a) *In general.* Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§ 1.861–10T, 1.861–11T, 1.861–12T, and 1.861–13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. The method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in § 1.861–10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under § 1.861–11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see § 1.882–5.

(b) *Interest equivalents*—(1) *Certain expenses and losses*—(i) *General rule.* Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.

(ii) Examples. The rule of this paragraph (b)(1) may be illustrated by the following examples.

Example 1. W, a domestic corporation, borrows from X two ounces of gold at a time when the spot price for gold is $500 per ounce. W agrees to return the two ounces of gold in six months. W sells the two ounces of gold to Y for $1000. W then enters into a contract with Z to purchase two ounces of gold six months in the future for $1,050. In exchange for the use of $1,000 in cash, W has sustained a loss of $50 on related transactions. This loss is subject to allocation and apportionment under the rules of this section in the same manner as interest expense.

Example 2. X, a domestic corporation with a dollar functional currency, borrows 100 pounds on January 1, 1987 for a three-year term at an interest rate greater than the applicable federal rate for dollar loans. At this time, the interest rate on the pound was approximately equal to the interest rate on dollar borrowings and the forward price on the pound, vis-a-vis the dollar, was approximately equal to the spot price. On January 1, 1987, X converted 100 pounds into dollars and entered into a currency swap that substantially hedged X's foreign currency exposure on the pound borrowing, both with respect to